Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:SCA:SD:POSTF-117937-02; 117938-02; 117941-02
GLGidlund
RECudlip

date: 5/7/02

to: David Simmons, Revenue Agent, San Diego

from: LMSB Practice Group, San Diego

---

subject: **ADVISORY OPINION: Section 382 Allocation**
Schedule M-1
Closing-of-the-Books Election

Taxpayer: [redacted] Inc.

EIN: [redacted]

This memorandum responds to your request for assistance dated March 25, 2002. This memorandum should not be cited as precedent.

ISSUE

1. Whether the period of limitations has expired for adjusting the taxpayer's net operating loss (NOL) carryover from the taxable year ending February 1, [redacted] to subsequent taxable years.

2. Whether an adjustment can be made to the taxpayer's allocation of expenses constituting the NOL between the pre-change and post-change portions of the change year (i.e., the year ending February 1, [redacted]) for purposes of determining the pre-change NOL subject to the I.R.C. section 382 limitation.

3. Whether an adjustment can be made relating to expenses as to which the taxpayer made an entry on its Schedule M-1, Reconciliation of Income (Loss) per Books With Income per Return, on its return for the taxable year ending February 1, [redacted], the period of limitations as to which has expired.

20169

4. Whether the taxpayer's failure to amend its return for the taxable year ending January 31, [redacted] provides cause under the conditions set forth in the private letter ruling to revoke the previously granted extension of time for filing the closing-of-the-books election or to otherwise treat the election as not having effect.

CONCLUSIONS

1. Even though the period of limitations may have expired as to the taxable years in which NOLs were generated, the Service may adjust the NOL carryover which the taxpayer is attempting to utilize in any subsequent year for which the period of limitations has not expired.

2. It is appropriate for the agent to ascertain whether the taxpayer correctly allocated expenses within the change year to the pre- and post-change periods to determine whether the taxpayer correctly computed the amount of pre-change NOL that will carryover and be subject to the I.R.C. section 382 limitation. (In doing the allocation analysis, since the taxpayer is an accrual basis taxpayer, the agent should look at those expenses in question and apply the all events test of I.R.C. section 461 to determine whether the date upon which the expense accrued is in the pre- or post-change period. If the agent requires assistance in making these determinations, we are, of course, available to assist; however, if our assistance is requested as to specific expenditures, it is necessary that we be provided with all information and documentation relating to any expenditures as to which you may seek assistance.)

3. The Schedule M-1 is a reconciliation schedule. The agent has represented that the taxpayer has deferred certain expenses, as reflected on the Schedule M-1. Any deferral would not be accomplished through the Schedule M-1 itself, rather it would be an indicator that an expense on the taxpayer's books was either not claimed as a deduction on the current tax return, or that the deduction, if claimed, was claimed in a lesser amount. In this case, the tax return for the taxable period ending February 1, [redacted] contained a substantial NOL. If the agent determines that an additional deduction should have been claimed on that return, or that a deduction should have been claimed in a larger amount, the NOL would be increased. As discussed above in issue 1, even though the period of limitations as to the taxable period ending February 1, [redacted] has expired, it is not too late to adjust the amount of the NOL carried over from that year to years for which the period of

limitations is open. In relation to issue 2, if the taxpayer is entitled to the closing-of-the-books election, it would be necessary for the agent to ascertain the precise date of accrual of the expense in order to determine whether the expense is a pre- or post-change period expense.

4. As the closing-of-the-books election had no net effect on the taxpayer's tax liability for its taxable year ending January 31, [redacted], the failure to amend the return for that taxable year does not violate the condition of the private letter ruling.

FACTS

This advice is dependent upon the accuracy of the facts and assumptions upon which this advice is based. You should review these facts and assumptions carefully for accuracy. If a fact or assumption is not accurate you should contact Counsel to ascertain the continuing validity of this advice.

The taxpayer is [redacted] Inc. & Subsidiaries ("the [redacted]"). The year under audit is the taxable year ending January 31, [redacted]. The periods of limitations for taxable years ending January 31, [redacted] and [redacted] are open. In [redacted], through a series of stock purchases, a greater than [redacted]% shift in ownership of the [redacted] occurred; thus, on the date of the final stock purchase, [redacted] an ownership change as defined in I.R.C. section 382(g) occurred.

The [redacted]'s taxable year which included the ownership change ended on February 1, [redacted]. The [redacted] had accumulated consolidated NOLs over the years. Prior to the year of the ownership change, the [redacted] had accumulated approximately $[redacted] of NOLs from taxable years ending December 31, [redacted] through [redacted]. In the year of the ownership change, the [redacted] incurred an additional loss of $[redacted]. The period of limitations for taxable year ending February 1, [redacted] has expired.

The [redacted] represents that it intended to allocate its $[redacted] of NOL generated during the ownership change year between the pre-change period (i.e., that portion of the February 1, [redacted] taxable year up to and including [redacted]) and the post-change period (i.e., that portion of the February 1, [redacted] taxable year from [redacted] through February 1, [redacted]) as if the books were closed on the change date (i.e., at the end of business on [redacted]). This would have required a timely irrevocable closing-of-the-books election on the tax return for the period ending February 1, [redacted] by its extended due date of [redacted].

The [redacted]'s then-return preparer, [redacted], for various reasons, failed to make the election and reported the transaction, as required by the statute in the absence of an election, on a pro-rata basis (i.e., the loss for the taxable year ending February 1, [redacted] was treated as having accrued ratably on a daily basis). Since the ownership change occurred approximately two weeks before the close of the taxable year, nearly all (i.e., approximately [redacted]/[redacted] or [redacted]) of the NOL was reported as pre-change NOL. In post-change tax years, the amount of the [redacted]'s taxable income against which pre-change NOLs may be applied cannot exceed the I.R.C. 382 section limitation for such year.

In April [redacted], approximately [redacted] years after the time for making the election, the [redacted]'s new return preparer, [redacted], discovered that the election had not been made and had not been reflected on the return. On [redacted], the [redacted] applied for an extension of time under Treas. Reg. section 301.9100-1 through -3 to file the closing-of-the-books election. The [redacted] supplemented its application with additional information in letters dated [redacted], [redacted], [redacted], [redacted] and [redacted].

On [redacted], the Service issued a private letter ruling (PLR) granting an extension until 30 days from the date of the letter ruling to file the election (by amending its information statement). The extension was based on the representations made by the [redacted] in connection with the request, and the extension was conditioned on:

(1) the filing, within 120 days of the letter ruling, of all returns (if any) necessary to reflect the Election, and

(2) the [redacted]'s tax liability (if any) being not lower, in the aggregate, for all years to which the election applies, than it would have been if the election had been timely made (taking into account the time value of money).

After permission was granted to make the closing-of-the-books election the [redacted] filed some amended returns, but not for taxable year ending January 31, [redacted]. For the taxable period ending February 1, [redacted], the taxpayer claimed a pre-change loss of $[redacted], and a post-change loss of $[redacted]. Thus, by changing to a closing-of-the-books method, the [redacted] was able to decrease the pre-change loss (i.e., the amount of its NOL carryover that was subject to the Section 382 limitation) and increase the post-change loss that was not subject to the Section 382 limitation. The post-change NOL increased from [redacted]% of the change-year loss to [redacted]% of the change-year loss, an increase of approximately [redacted] fold. Given that the change date was approximately [redacted] prior to the end of the taxable year, it is apparent that a significant amount of expenses were claimed as having been incurred in the post-change period. By electing the closing-of-the-books method, the taxpayer moved approximately $[redacted] in expenses from the pre-change period to the post-change period.

As to the [redacted]'s closing-of-the-books allocation and M-1 adjustments, the revenue agent has noted the following:

(1) There is a $[redacted] expense for gross separation payments to the prior owners. In the closing-of-the-books allocation, the entire amount was allocated to the two-week post-change period. This amount was paid pursuant to a Separation Agreement.

(2) There are certain additional expenses per the [redacted]'s books incurred during the 50-week pre-change period ending on [redacted], for which the [redacted] made a reconciling entry on its Schedule M-1 effectively decreasing the pre-change loss by deferring the deductions for tax purposes into a post-change year not subject to the section 382 limitation, as follows:

	Per Books	Sch. M-1 Entry
[redacted] Trust	$[redacted]	$[redacted]
[redacted] Group	[redacted]	[redacted]
Settlement Payments	[redacted]	[redacted]

Directors' & Officers' Run Off Insurance [redacted] $[redacted] [redacted] $[redacted]

The revenue agent has provided us with the following information concerning the expenses affected by the Schedule M-1 reconciling entry:

a. [redacted] Trust. On page 7 of the request for advice, the agent has stated "Payments made to [redacted] Trust on or about [redacted], and were paid to the individuals during [redacted]." On page 4 of the request for advice, the agent has made an annotation that the entire amount of the [redacted] Trust payments of $[redacted] relate to the Separation Agreement. On page four, the agent states "The issue is whether the above settlement charges, related to the change in ownership, occurred during the pre-change period or the post-change period." The agent subsequently told us that an M-1 reconciling entry was made for the entire $[redacted].

b. [redacted] Group. On pages 3 and 4 of the request for advice, the agent refers to an $[redacted] expense for payment of future [redacted] Grp. Expenses. The agent subsequently told us that an M-1 reconciling entry was made for $[redacted] of this amount. The request for advice also has a reference to a Letter Agreement. The agent states as follows:

> The letter agreement indicates payments through [redacted] for the Lease of the [redacted] office, to include utility charges, office equipment and cleaning cost, salaries and benefits and other expenses relating to the employees in the [redacted] Office up to, but not in excess of the total in [redacted] and [redacted] which is $[redacted] minus certain payments. Also, schedule monthly payments of the auto leases.

c. Settlement payments. On pages 3 & 4 of the request for advice, the agent refers to a $[redacted] expense for settlement/severance payments. The agent subsequently told us that an M-1 reconciling entry was made for $[redacted] of this amount.

d. D&O Run-off insurance policy. On pages 3 & 4 of the request for advice, the agent refers to a $[redacted] expense for D&O Run-off insurance policy. The agent

> subsequently told us that an M-1 reconciling entry was made for $[redacted] of this amount.

The revenue agent also provided the following information:

> The [redacted] Financial Statement states that [redacted] of the special charges relate to terminating contracts with the former principal executive officers and $[redacted] to cancel certain contracts and expenses related to the separation and closure of the former executive offices in [redacted] in connection with the change in control. At the end of [redacted], the future payments totaling $[redacted] related to these special charges were included in accrued liabilities.

ANALYSIS

A. I.R.C. Section 382

Under I.R.C. section 382, limitations are imposed on a purchasing company's ability to use a purchased company's ("loss corporation's") pre-change tax losses. After an ownership change occurs, the amount of the loss corporation's taxable income for a post-change tax year against which pre-change losses may be applied cannot exceed the section 382 limitation for such year.[1]

The loss corporation's taxable year in which the change date occurs is called the "change year." I.R.C. § 382(d)(2). When the ownership change occurs during a tax year, as opposed to on the last day of the tax year, the loss for that year must be divided. When a change year includes the change date, the year must be divided into two parts: one part (the "pre-change period") includes the days of the year up to and including the change date (Treas. Reg. § 1.382-6(g)(2)); and the other part (the "post-change period") consists of all the rest of the days in that taxable year (Treas. Reg. § 1.382-6(g)(3)). The general rule ratably allocates an equal amount of that loss between the

[1] The section 382 limitation is applied annually and generally equals the value of the [redacted] stock immediately before the ownership change multiplied by the federal long-term tax-exempt rate. This limitation also applies to limit the use of certain built-in losses (whether capital or ordinary in character) recognized by the loss corporation after an ownership change. Such limitation for a tax year may be increased by certain items such as an unused limitation for a prior tax year or certain built-in gains recognized during the recognition period.

pre-change part of the year and the post-change part of the year on a daily basis. I.R.C. § 382(d).

In Notice 87-79, 1987-2 C.B. 387, the IRS announced that it would allow an exception for loss corporations to close their books as of the change date provided that a private letter ruling was applied for that permitted such method. Notice 87-79 also announced the Service's intention to issue regulations providing for a closing-of-the-books election. The Service later promulgated a regulation permitting election to be made by a statement attached to the tax return for the change year on or before the due date (including extensions) of the loss corporation's income tax return for the change year. See Treas. Reg. § 1.382-6(b). Income and loss could be allocated between the pre-change period and the post-change period according to the loss corporation's actual results. In the absence of the election, however, ratable daily proration would continue to be the general rule.

B. Issue 1: The period of limitations has not expired for adjusting the taxpayer's NOL carryover from the taxable year ending February 1, [redacted] to subsequent taxable years.

The Tax Court has jurisdiction to determine a deficiency in or overpayment of tax by a taxpayer only for those years with respect to which a notice of deficiency has been mailed by the Commissioner to such taxpayer. The jurisdiction of the court over other years is limited to consideration of such facts as may be necessary to correctly redetermine the taxpayer's tax liability for a year with respect to which a deficiency notice has been mailed to the petitioner. I.R.C. §§ 6212, 6213, and 6214. It is well settled that the Tax Court may determine the correct amount of taxable income or NOL for a year not in issue (whether or not the assessment of a deficiency for that year is barred) as a preliminary step in determining the correct amount of a NOL carryover to a taxable year in issue. Harris v. Commissioner, T.C. Memo. 1970-331; aff'd per curiam, 73-1 U.S.T.C. ¶ 9205 (9th Cir.); cert. den., 410 U.S 966 (1973). ABKCO Industries, Inc., 56 T.C. 1083, 1088-89 (1971), aff'd on another issue, 482 F.2d 150 (3d Cir. 1973); Lone Manor Farms, Inc. v. Commissioner, 61 T.C. 436 (1974), aff'd, 510 F.2d 970 (3d Cir. 1975).

C. Issue 2: An adjustment can be made to the taxpayer's allocation of expenses constituting the NOL between the pre-change and post-change portions of the taxable year ending February 1, [redacted] for purposes of determining the NOL subject to the I.R.C. section 382 limitation.

I.R.C. section 461 provides the general rule for the taxable year of a deduction. The deduction is taken in the taxable year which is the proper taxable year under the method of accounting used in computing taxable income. I.R.C. § 461. Under an accrual method of accounting, a liability (as defined in Treas. Reg. § 1.446-1(c)(1)(ii)(B)) is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. Treas. Reg. § 1.461-1(a)(2)(ii).

Principles for determining when economic performance occurs are set forth in I.R.C. section 461(h)(2) and Treas. Reg. section 1.461-4.

In determining whether an expense from the taxpayer's taxable year ending February 1, [redacted] is an expense attributable to a pre-change period, or the post-change period, you would look to see whether the taxpayer became entitled to take the deduction on a pre-change date or on a post-change date. The taxpayer becomes entitled to take the deduction when:

1. the all events test is met:

   a. all events that determine the fact of the taxpayer's liability for the expense have occurred, and

   b. the amount of the liability can be determined with reasonable certainty), and

2. economic performance has occurred.

Thus, the agent needs to determine whether under the facts and circumstances of this case, the taxpayer has claimed appropriate pre-change period deductions and not deferred them incorrectly into the post-change period.

If you need assistance with specific expenses, please submit a request for advice containing as much information as possible about such expenses, including the following information:

- the amounts,
- the specific dates each expense was paid,
- the taxable year in which the taxpayer claimed the deduction,
- all documentation relating to when the liability was established,

- all documentation relating to the facts as to which the amount of the liability was established with reasonable certainty,
- all information concerning economic performance, and
- the agent's position setting forth the agent's reasoning regarding adjusting the expense.

D. Issue 3: The NOL carryover from the taxable year ending February 1, [redacted], can be increased for certain deductions for which it is determined that the taxpayer made erroneous reconciling entries on the Schedule M-1.

I.R.C. section 446(a) requires conformity with book and taxable income. Book and taxable income must be compared and the differences reconciled. The starting point for the examination of books and records is the reconciliation of tax return to the books. There are numerous differences between Generally Accepted Accounting Principles (GAAP) used for book purposes and tax law. These differences for corporate taxpayers should appear on Schedule M-1 of the income tax return.

Schedule M-1 of Form 1120 is a schedule attached to the corporate return and is intended to achieve what its caption suggests: Reconciliation of Income Per Books With Income Per Return. See Southwestern Energy Company and Subsidiaries v. Commissioner, 100 T.C. 500 (1993).

Reconciliation can be accomplished by comparing the amount on line 1 of the Schedule M-1 to the net income per books and the amount on line 10 of Schedule M-1 to line 28 on page 1 of the return. Schedule M-1 is a critical schedule for identifying potential tax issues resulting from both temporary and permanent differences between financial and tax accounting. For a corporation, Schedule M-1 is the reconciliation between net income per the books and taxable income before the NOL deduction, dividends received, and the special deductions per Schedule C. IRM § 4.10.3.6.1, Examination Techniques. Numerous differences are frequently encountered in reporting for financial statement purposes and for income tax purposes, and those differences are reconciled on Schedule M-1.

The Schedule M-1 is not an item of income or deduction, loss or credit. As stated above, it is a reconciliation schedule. The agent has represented that the taxpayer has deferred certain expenses, as reflected on the Schedule M-1. Any deferral would not be accomplished through the Schedule M-1 itself, rather it would be an indicator that an expense was either not claimed as a deduction on the current tax return, or that the deduction, if claimed, was claimed in a lesser amount. In this case, the tax return for the taxable period ending February 1, [redacted], contained a substantial NOL. If the agent determines that an additional deduction should have been taken on that return, or that a deduction should have been taken in a larger amount, the NOL would be increased. As discussed above in issue 1, even though the period of limitations as to the taxable period ending February 1, [redacted], has expired, it is not too late to adjust the amount of the NOL carried over from that year to subsequent years for which the period of limitations is open. In relation to issue 2, if the taxpayer is entitled to the closing-of-the-books election, it would be necessary for the agent to ascertain the precise date of accrual of the expense in order to determine whether the expense is a pre- or post-change period expense.

E. <u>Issue 4:</u> Since any return amended for the taxpayer's taxable year ending January 31, [redacted] would not reflect the closing-of-the-books election, the taxpayer is not required under the terms of the private letter (PLR) ruling to so amend.

The PLR granting the extension of time for the taxpayer to file the closing-of-the-books election was conditioned on "the filing, within 120 days of the issuance of this letter ruling, of all returns and amended returns (if any) necessary to reflect the Election." The taxpayer did not file an amended return for the taxable year ending January 31, [redacted], but the agent concedes (and our review of the facts confirms) that the closing-of-the-books election caused no change to the taxpayer's liability for that year or to its tax situation generally, so as to otherwise require the filing an amended return under normal circumstances.

The agent has asked whether an amended return or other statement, report, or rider is nonetheless required as a "compliance" or "information purposes" matter in order to signal or "bookmark" in the tax history of the case that certain NOL deductions consist in part of losses limited by section 382 and in part of unlimited post-change losses. We have consulted informally with our National Office (specifically the author of the PLR) on this matter, and the conclusion is that, in the absence of any potential abuse, which we have not found, no need exists to amend the return.

This conclusion is supported by our review of the case law. The leading case on this general subject of adherence to conditions imposed in a PLR is <u>Gerli & Co., Inc. v. Commissioner</u>, 668 F.2d 691 (2d Cir. 1982), <u>rev'g</u> 73 T.C. 1019 (1980), where the taxpayer requested a ruling that its liquidation of a Canadian subsidiary be accorded tax-free treatment under I.R.C. section

332. Such a ruling was needed because I.R.C. section 367 provided that section 332 applied to foreign corporations only if the Service was satisfied that the liquidation was not in pursuit of a plan having income-tax-avoidance as one of its principal purposes. The Service issued a favorable ruling but imposed the condition that the taxpayer must include in income the accumulated and current earnings and profits of the Canadian subsidiary. Previously, the Service had relied on the inclusion of such items in income as one of three disjunctive factors in demonstrating lack of income-tax-avoidance purpose, although a subsequent revenue procedure, Rev. Proc. 68-23, 1968-1 C.B. 821, announced that taxpayers were free to attempt to prove lack of income-tax-avoidance purpose based on all the facts and circumstances. Gerli, 668 F.2d at 695

In Gerli, for the taxable year of the liquidation, the taxpayer did not include in income the accumulated and current earnings and profits of the Canadian subsidiary, thus failing to adhere to an explicit condition of the ruling. The Service then issued a notice of deficiency, denying the taxpayer the benefit of the ruling by treating the liquidation as a taxable one, from which notice the taxpayer filed a Tax Court petition. The Tax Court agreed with the Service's position, holding that since the taxpayer chose not to adhere to a condition of the ruling, the liquidation of the Canadian subsidiary failed to qualify for tax-free treatment under section 332. Gerli, 73 T.C. at 1028-29. The Second Circuit Court of Appeals reversed the Tax Court, however, holding that the imposition of this condition of the inclusion of certain items in income (the Second Circuit adopted the commonly used term "toll charge") was not a reasonable or acceptable substitute for the Service simply determining on all the facts and circumstances whether one of the principal purposes of the liquidation plan was tax avoidance. Gerli, 668 F.2d at 699. Nothing in section 367 or its legislative history suggested that the Service could impose a "condition having no necessary logical relation to the issue determined." Id. at 697. In its review of the facts, the Second Circuit found that the Canadian subsidiary, which had been in business for thirty-seven years, was plainly not organized for income-tax-avoidance purposes and noted additionally that Canada was hardly a tax haven. On the facts of the case, then, the condition of the ruling was an improper one, thereby relieving the taxpayer of any obligation of adherence to it and enabling treatment of the liquidation as a tax-free transaction.

Admittedly, the facts of Gerli are quite particular to situations involving sections 332 and 367. (And in fact, the Second Circuit was careful to limit its opinion to the facts of the case. Gerli, 668 F.2d at 699. Moreover, the Tax Court has appeared keen to apply Gerli narrowly, if at all. See Sherwood Properties, Inc. v. Commissioner, 89 T.C. 651, 672-73 & n.20 (1987).) Most broadly, Gerli can be read as preventing the Service from imposing conditions on taxpayer relief once the taxpayer has met all conditions imposed by Congress. Cf. Union Pacific Railroad Co. v. United States, 86-1 U.S.T.C. ¶ 9259 (Cl. Ct. 1986) (Gerli distinguished where the Service imposes conditions on a taxpayer's accounting methods, an area where the Service has discretion to act to clearly reflect income). In our case, by contrast, the test for granting a favorable ruling derives from a regulation, not a statute enacted by Congress. As a result, the Service arguably has greater discretion to impose conditions. Nevertheless, the conditions for granting relief with regard to a regulatory election are clearly set forth in Treas. Reg. § 301.9100-3, and the PLR finds that these conditions are established.

Consequently, even assuming that some compliance requirement exists with regard to filing an amended return, we seriously doubt that such a condition would be enforced by the courts.

If you have any questions concerning this advisory opinion, please direct them to the undersigned at (619) 557-6014. Thank you.

DISCLOSURE STATEMENT

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

GORDON L. GIDLUND
Associate Area Counsel (LMSB)

ROBERT E. CUDLIP
Attorney